

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:LM:RFP:MIA:POSTF-150417-01  
AAmmirato

date: June 26,2002

to: [REDACTED], Team Manager (LMSB), Group [REDACTED]

from: Area Counsel  
(Heavy Manufacturing and Transportation:Edison)

subject: [REDACTED]

**Taxable Years Ending December 31, [REDACTED], December 31, [REDACTED]  
December 31, [REDACTED], and December 31, [REDACTED]**

**This memorandum responds to your request for assistance.  
This memorandum should not be cited as precedent.**

**This issue was coordinated with Industry Counsel Tamara  
Moravia-Israel (LMSB) IC Shipping and Marine.**

**ISSUE**

Whether [REDACTED] is required to withhold a United States tax pursuant to I.R.C. §§ 881(a) and 871(a) on rental payments made to third party leasing companies whose containers are used by [REDACTED] within the United States.

**FACTS<sup>1</sup>**

[REDACTED], (hereinafter referred to as "[REDACTED]"), is the United States parent of the United States affiliated group and is wholly owned by [REDACTED] (hereinafter referred to as "[REDACTED]"). [REDACTED] is a shipping partnership<sup>2</sup> headquartered in [REDACTED] whose fleet consists of approximately [REDACTED] vessels, (including container vessels) and shipping containers. In addition to their company owned shipping containers, [REDACTED] leases additional containers from third parties (hereinafter referred to as "third party leasing companies"). The audit team has not

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<sup>1</sup> The following facts were taken from the [REDACTED] United States Transfer Pricing Analysis, dated December 31, 1997.

<sup>2</sup> The [REDACTED] partnership is ultimately owned by [REDACTED] public corporations.

identified the third party leasing companies, the countries in which they are organized, or whether their containers were used by [REDACTED] within the United States.

[REDACTED] filed Form 1120-F for each of the years at issue and attached a statement of exemption under I.R.C. § 883. In addition, [REDACTED] attached to its tax return a "Treaty-Based Return Position under I.R.C. § 6114." [REDACTED] states that it does not have a permanent establishment, (hereinafter referred to as "PE"), within the United States.

[REDACTED] acts as a liaison between [REDACTED] and [REDACTED]'s United States customers with respect to the import and export of cargo shipped on the vessels and containers owned by [REDACTED]. [REDACTED] essentially acts as a freight forwarder. [REDACTED] Company, (hereinafter referred to as "[REDACTED]"), which is a wholly owned United States subsidiary of [REDACTED], leases equipment such as container chassis and refrigeration gensets to [REDACTED] in order to facilitate the transport of the cargo on the inland portion of the voyage.

Agreements were entered into between the above-mentioned parties which outline the functions performed and fee arrangements.<sup>3</sup> The agreement between [REDACTED] and [REDACTED] provides the following:

[REDACTED]

[REDACTED]

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<sup>3</sup> The current agreements amongst and between [REDACTED], [REDACTED], and [REDACTED] were originally entered into on [REDACTED]. The agreements binding on the parties for the audit years [REDACTED] through [REDACTED] are amended versions of the initial agreements.

[REDACTED]

[REDACTED]

[REDACTED]

The audit team has not raised an arm's length issue under I.R.C. § 482 regarding the commissions paid to [REDACTED] for its services performed for [REDACTED]. Furthermore, the audit team has not challenged [REDACTED]'s position that it does not have a PE in the United States pursuant to the United States/[REDACTED] Tax Treaty.

The objective of this memorandum is to provide assistance in identifying the third party leasing companies and determining whether the leased containers were used within the United States. The memorandum also discusses the potential United States tax consequences on the third party leasing companies assuming that the leased containers were utilized by [REDACTED] within the United States.

#### LAW AND ANALYSIS

For purposes of the sourcing rules of I.R.C. §863(c), "transportation income" means any income derived from, or in connection with, 1) the use (or hiring or leasing for use) of a vessel or aircraft, or 2) the performance of services directly related to the use of any vessel or aircraft. I.R.C. § 863(c)(3). The term "vessel" includes any container used in connection with a vessel or aircraft. Id. Fifty percent of all transportation income which begins or ends in the U.S. is United States source income. I.R.C. § 863(c)(2).

"Income derived from or in connection with, the use (or hiring or leasing for use) of any vessel or aircraft" means: 1) income derived from transporting passengers or property by vessel or aircraft; 2) income derived from hiring or leasing a vessel or aircraft for use in the transportation of passengers or property on the vessel or aircraft; and 3) income derived by equipment ("container related income") in connection with, or incidental

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<sup>4</sup> The primary reason for the disparity in commission rates is due to the fact that [REDACTED]'s liaison functions with [REDACTED]'s United States customers is greater for outbound rather than for inbound transactions.

to, the transportation of cargo on such vessels or aircraft by the operator. Persons other than an operator of a vessel or aircraft do not derive "container related income". Such income to non-operators is treated as rental income, not transportation income. See Rev. Proc. 91-12, 1991-1 C.B. 471, sec. 2.04.

"Operator" includes the actual operator of a vessel or aircraft, as well as a time or voyage charterer of such vessel or aircraft. *Id.* at sec. 2.06. Thus, the income of such non-operators (i.e. the third party leasing companies) is sourced as rental income.

I.R.C. § 883(a)(1) exempts from United States tax the gross income of a corporation organized in a foreign country from the international operation of ships or aircraft if such foreign country grants an equivalent exemption to corporations organized in the United States.<sup>5</sup> I.R.C. § 883(a)(4) (by reference to I.R.C. § 872(b)(5)) extends the exemption to income derived by a foreign corporation from the rental (on a full or bareboat basis) of ships or aircraft. The exemption under I.R.C. § 883(a)(1) only applies to operators of ships or aircrafts. Activities described in Prop. Treas. Reg. § 1.883-1(e) do not constitute operation of ships or aircraft whether or not conducted by a person that is an operator of ships or aircraft. Included in paragraph (e)(4) of this section is the rental by a container leasing company of containers and related equipment. Thus, rental income received by third party leasing companies is not exempt under I.R.C. § 883(a)(1).

I.R.C. § 881 imposes a 30 percent gross tax on rents received by a foreign corporation from sources within the United States. The tax is based on the gross rents received by the foreign corporation and does not permit the allocation of any expenses related to the rental income. A particular tax treaty entered into by the United States may eliminate or reduce the withholding tax imposed pursuant to I.R.C. § 881. See I.R.C. § 894.

The collection of a tax imposed pursuant to I.R.C. § 881 is effected through a withholding obligation of the person or entity

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<sup>5</sup> If a taxpayer takes the position that the income is exempt from federal tax under I.R.C. § 883, a taxpayer must file a return to claim the exemption providing the information as required pursuant to Rev. Proc. 91-12, 1991-1 C.B. 473, section 8. If a taxpayer takes the position that an exemption applies under an income tax convention, it must comply with the filing requirements under I.R.C. § 6114 ("Treaty Based Return Position") and the regulations thereunder. *Id.*

making the payment. See I.R.C. §§ 1441 and 1442.<sup>6</sup> I.R.C. § 1441 imposes a withholding obligation on "all persons, in whatever capacity acting ... having the control, receipt, custody, disposal, or payment of any items of income specified in I.R.C. § 1441(b)... (to the extent that any such item constitutes gross income from sources within the United States), of any nonresident alien or foreign partnership".

### **1. Tax Consequences on the Third Party Leasing Companies.**

Once it is confirmed that [REDACTED] uses containers leased from third party leasing companies within the United States, the United States tax consequences of lease payments can be determined. If a third party leasing company is a foreign person which has a United States trade or business or has a PE within the United States, then the rental payments will not be subject to a withholding tax under I.R.C. §§ 881 and 871(a).<sup>7</sup>

However, if a third party leasing company is not engaged in a United States trade or business and does not have a PE within the United States, then a withholding tax will apply to the lease payments pursuant to I.R.C. §§ 881(a) and 871(a), as the payments received by the third party leasing company will be considered rental income. As discussed above, said income will be treated as rental income and not transportation income pursuant to Rev. Proc. 91-12, 1991-1 C.B. 473. Further, as per Prop. Treas. Reg. § 1.883-1(e)(4), I.R.C. § 883 does not provide an exemption from United States tax on the income earned from the lease of such containers.

Since the lease payments will be treated as rental income and not transportation income, I.R.C. § 861 or § 862 applies in sourcing such income. Rental payment for the use of shipping containers within the United States is treated as income from sources within the United States pursuant to I.R.C. § 861(a)(4) and Treas. Reg. § 1.861-5. Rental payments for the use of shipping containers outside the United States is treated as foreign source income. See I.R.C. § 862(a)(4). The audit team would need to determine the amount of time the containers were used by lessee ([REDACTED]) within the United States in order to determine the total lease payments allocated as United States

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<sup>6</sup> I.R.C. § 1442 imposes the same withholding obligation on payments to foreign corporations.

<sup>7</sup> The United States tax return filed by the third party leasing company would need to be examined to ensure proper compliance.

source income. The United States sourced lease payment would generally be subject to a 30% United States withholding tax.<sup>8</sup>

## **2. Withholding Obligation.**

In connection with the rental payments which are subject to a withholding tax pursuant to I.R.C. §§ 881(a) and 871(a), [REDACTED] would be required to withhold the tax pursuant to I.R.C. §§ 1441 or 1442. A withholding agent is any person, United States or foreign, that has custody, disposal, or payment of an item of income of a foreign person subject to withholding. Treas. Reg. § 1.1441-7(a). [REDACTED] would be required to file an annual return of the tax withheld on Form 1042. An original copy of Form 1042 must be filed on or before March 15 of the year following the calendar year in which the tax was required to be withheld. Treas. Reg. § 1.1461-1(b)(1). An information return, Form 1042S, must also be filed to report amount paid to a foreign payee subject to withholding. Treas. Reg. § 1.1461-1(c)(1). [REDACTED] may be held liable pursuant to I.R.C. § 1461 for the amount of tax required to be withheld.

[REDACTED] would be required to withhold a United States tax on rental payments unless a withholding certificate is provided by the third party leasing company establishing that the payment is effectively connected with a trade or business or attributable to a PE or that it is entitled to a reduced rate pursuant to a Tax Treaty. See Treas. Reg. §§ 1.1441-4(a)(2) and § 1.1441-6(b).

## **3. Identifying the Third Party Leasing Companies.**

As indicated above, in determining the potential United States tax consequences on third party leasing companies, the audit team must ascertain: 1) whether [REDACTED] leased containers from foreign third party leasing companies; 2) whether such containers were used by [REDACTED] within the United States; and 3) the amount of time such containers were used within the United States. The audit team needs to obtain the lease agreements entered into by and between [REDACTED] and the third party leasing companies, as well as other documents related to the leasing arrangements.

We recommend that a meeting be arranged with [REDACTED] to discuss the

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<sup>8</sup> However, the audit team would need to determine the residence of the third party leasing company in order to ascertain whether an applicable tax treaty reduces or eliminates the withholding tax.

issue and attempt to obtain the relevant information and records. The audit team should issue IDRs to [REDACTED] and [REDACTED]. In the event that the information is not obtained voluntarily, we recommend that Article 26 (Exchange of Information) of the United States/[REDACTED] Tax Treaty be utilized.

### **CONCLUSION**

Based on the above discussion, if it is determined that [REDACTED] leases containers from third party leasing companies for use within the United States, said leasing companies may be subject to withholding pursuant to I.R.C. §§ 881(a) and 871(a).

This advisory opinion has been reviewed by the National Office. If you have any questions regarding the foregoing, please contact Anthony Ammirato at (212)436-1446.

**This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.**

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By: \_\_\_\_\_  
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